No. 82-1200

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

DAILY INCOME FUND, INC. and REICH & TANG, INC.,
Petitioners,

—v.—

MARTIN FOX,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' REPLY BRIEF

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Overview

Respondent concedes, at least implicitly, that Rule 23.1 requires a demand by a shareholder on the directors in a derivative action. Respondent argues, however, that a shareholder's action under § 36(b) is not a derivative action. The underpinning of Respondent's argument is that an investment company itself allegedly has no implied right of action to recover excessive advisory fees from its investment adviser.

Respondent's argument is without merit and, if adopted, would work an utterly incongruous result. Consider the following: if a new slate of directors of an investment company, upon reviewing the work of their predecessors, concluded that the investment company had been charged excessive advisory fees, could Congress possibly have intended to prevent the new slate of directors from instituting an action to recover excessive advisory fees? Even if no shareholder raised the matter? Obviously not. It makes no sense whatever to suggest that Congress intended to leave an investment company powerless to recover excessive advisory fees because a *shareholder* does not happen to raise the matter.

In short, under Respondent's interpretation of § 36(b), the independent directors would have less power than a single shareholder to recover excessive advisory fees, despite the independent directors' undeniable legal responsibility for the management of the investment company. This result would clearly conflict with the purpose of § 36(b), which was "designed to strengthen the ability of the unaffiliated directors to deal with these matters." S. Rep. No. 184, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. & Admin. News 4897, 4903.

Reply to Point I—

A shareholder's action under § 36(b) is derivative and, accordingly, Rule 23.1 is applicable.

The language and the legislative history of § 36(b) demonstrate that Congress considered a shareholder's action under § 36(b) to be derivative.

First, as argued in our main brief, the language of § 36(b) itself (". . . on behalf of such company . . .") indicates that a shareholder's action is derivative (Petitioners' Brief, p.5). See *Burks* v. *Lasker*, 441 U.S. 471, 477 (1979).

Second, as also argued in our main brief, the legislative history of § 36(b) evidences the fact that Congress considered a shareholder's action under § 36(b) to be derivative (Petitioners' Brief, pp. 6-8; see also ICI Brief, pp. 19-24).

At the heart of Respondent's contention that a shareholder's action under § 36(b) is not derivative and that Rule 23.1 therefore does not apply,[1] is the argument that an investment company itself allegedly has no implied right of action under § 36(b) to recover excessive advisory fees. That argument is based on an erroneous view of the legislative history of § 36(b).

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1 The SEC, which has filed an amicus curiae brief in this case despite its lack of any special expertise on the Federal Rules of Civil Procedure, takes the position that Rule 23.1 does not itself require that demand be made but only that the fact of such demand or the excuse for lack of demand be pleaded (SEC Brief, pp. 7-8). Although Rule 23.1 is worded as a pleading requirement, its history clearly establishes that it is intended to require director demand, and the courts have uniformly interpreted it this way. See 3B Moore's Federal Practice ¶¶ 23.1.15[4] and 23.1.19 (2d ed. 1980).

Respondent first argues that a right of action should not be implied since Congress has provided an express remedy to a shareholder and the SEC, as part of "a comprehensive legislative scheme" (Respondent's Brief, p. 6). The flaw in this argument is that the ICA is not, as Respondent claims, "a comprehensive legislative scheme." Rather, as this Court held in *Burks* v. *Lasker, supra*, 441 U.S. at 478, it is state corporation law, not the ICA, which is the source of authority for the managerial powers of investment company directors. Accordingly, the absence of any express authorization in § 36(b) for an action by an investment company should not be interpreted to restrict the company's right to sue. *Weiss* v. *Temporary Investment Fund, Inc.*, 692 F.2d 928, 935 (3d Cir. 1982).

In addition, as this Court reiterated in *Herman & MacLean* v. *Huddleston*, ____ U.S. ____, 103 S.Ct. 683, 690 n.23 (1983), the canon of statutory construction which opposes the implication of a remedy because another remedy has been expressly provided should be " 'subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose.' " As this Court held in *Burks* v. *Lasker, supra,* 441 U.S. at 484-85, the dominating general purpose of the 1970 amendments to the ICA, which included § 36(b), was to strengthen the role of the independent directors. To deny an investment company a right of action under § 36(b), and thereby to permit a shareholder to bypass the independent directors by bringing a § 36(b) action without making a director demand, is inconsistent with that purpose and this Court's holding in *Burks*.

Respondent next argues that the rejection by Congress of a bill proposed by the Investment Company Institute ("ICI"), which specifically authorized an investment com-

pany to sue to recover excessive advisory fees but denied such right of action to the SEC, demonstrates that Congress did not intend to permit an investment company to bring a § 36(b) action (Respondent's Brief, pp. 8-10). However, there is no evidence in the legislative history that Congress considered and expressly rejected the idea of authorizing an investment company to sue for recovery of excessive advisory fees. Rather, the issue which was debated was whether the *SEC* should be authorized to sue for the recovery of excessive advisory fees. As the SEC admits (SEC Brief, p. 18), the ICI's proposed bill was rejected because of its negation of SEC suits, not because of its express recognition of investment company suits.[2]

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2 The SEC points out that other proposed bills authorized the SEC to intervene in suits to enforce the fiduciary duty of advisers brought "by or on behalf of a registered investment company", whereas § 44, as passed, permits SEC intervention in any § 36(b) action, and § 36(b) refers specifically only to suits by shareholders on behalf of the investment company (SEC Brief, pp. 17-19). From this subtle change in a provision that did not even deal with private rights of action, the SEC contends that Congress manifested its intent to deny to investment companies the authority to assert on their own behalf the right to recover excessive advisory fees. However, there is not a single word in the legislative history indicating that this was the reason for the change. "[S]tatutory interpretation cannot rest on unexplained actions of a Congressional committee." *United States* v. *Imperial Irrigation District*, 559 F.2d 509, 535 (9th Cir. 1977). The change in the language of the provision dealing with SEC intervention might just as reasonably have reflected Congress' awareness that a shareholder's action was derivative and that it was therefore unnecessary to specify that a suit to recover excessive advisory fees could also be brought by an investment company. See *United States* v. *Wise*, 370 U.S. 405, 411 (1962). In view of the whole thrust of § 36(b) to strengthen the role of the independent directors, it is highly unlikely that Congress would have deprived them of this remedy without a word of comment. See *Watt* v. *Alaska*, 451 U.S. 259, 271 n.13 (1981).

Respondent then argues against an investment company's right of action under § 36(b) by pointing to the evidence of Congressional intent to provide shareholders with an effective remedy for excessive advisory fees (Respondent's Brief, pp. 10-13). This argument proves nothing. The implication of a right of action by an investment company would not in any way diminish the effectiveness of the shareholders' remedy—it would merely add another remedy. As this Court recognized in *Herman & MacLean* v. *Huddleston*, *supra*, 103 S.Ct. at 689, such a "cumulative construction" of a statute to provide additional remedies is to be favored where, as here, it furthers the "broad remedial purposes" of the statute.

Nor is an investment company's right of action under § 36(b) inconsistent with the purpose of § 36(b). As Respondent concedes, § 36(b) was intended "to strengthen the role of disinterested directors" with respect to advisory fees (Respondent's Brief, p. 13). This Court "cannot interpret federal statutes to negate their own stated purposes." *New York State Department of Social Services* v. *Dublino*, 413 U.S. 405, 419-20 (1973). Contrary to Respondent's bare assertion (Respondent's Brief, p. 13), there is no evidence that Congress "mandated" a conflict between the goals of strengthening the role of the independent directors and providing an effective judicial remedy. Accordingly, § 36(b) should be interpreted to further its overall purpose of preventing excessive advisory fees. See *FTC* v. *Meyer*, 390 U.S. 341, 349 (1968). The implication of a right of action under § 36(b) by an investment company is clearly consistent with that purpose.[3]

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3 In a similar vein, the SEC argues that the legislative history of § 36(b) reflects "a congressional determination that, due to

Respondent also challenges our reliance on the testimony of Chairman Budge of the SEC, claiming that he intended to refer to Rule 23, not Rule 23.1 (Respondent's Brief, pp. 14-16).[4] However, Chairman Budge's testimony dealt with the subject of safeguards against frivolous or harassing "shareholder actions." Hearings on H.R. 11995, S.2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. at 201 (1969). Rule 23.1 sets forth the requirements applicable to a shareholder's action, whereas Rule 23, by contrast, is concerned with class actions. A shareholder's action to recover excessive advisory fees (both before and after the 1970 amendments to the ICA) is brought on behalf of the investment company to enforce secondary, not primary, rights of the shareholder. Thus, Rule 23.1, not Rule 23, is applicable to such an action.

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conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors" and that this determination "is fundamentally inconsistent with the underlying rationale of the traditional demand requirement." (SEC Brief, p. 9). This argument misconstrues Congress' decision to provide judicial review of advisory fee contracts as demonstrating a complete and utter distrust of any involvement by the directors in the process of assessing the fairness of those fees. Such a conclusion conflicts with the purpose of the ICA to make the independent directors the "watchdogs" of the investment company's affairs. The director demand requirement, by giving the independent directors an opportunity to resolve a fee dispute short of litigation is consistent *both* with the purpose of strengthening the role of the independent directors *and* with that of providing an effective judicial remedy if litigation should ensue.

4 The requirements for derivative actions were previously contained in Rule 23(b) and were moved to Rule 23.1 by the 1967 amendments to the Federal Rules of Civil Procedure.

See 3B Moore's Federal Practice, *supra*, ¶ 23.1.16[1] at 23.1-42. Indeed, Respondent has failed to cite a single case which has treated a § 36(b) action, or its common law or statutory predecessor, as a class action or has applied Rule 23. It is therefore apparent that Chairman Budge meant to refer to Rule 23.1, not Rule 23, in speaking of the existing safeguards against frivolous shareholder actions, as the Courts of Appeals for both the First and Third Circuits concluded. *Grossman* v. *Johnson*, *supra*, 674 F.2d at 122; *Weiss* v. *Temporary Fund, Inc.*, *supra*, 692 F.2d at 938.[5]

In arguing that a shareholder's action is not "strictly speaking" a derivative action, Respondent compares § 36(b) to § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (Respondent's Brief, pp. 15-16, n.6). That analogy has been rejected as specious by every court that has considered it because § 16(b) contains its own express director demand language. *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 938-39; *Grossman* v. *Johnson*, *supra*, 674 F.2d at 120.[6]

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5 The SEC claims that even if Chairman Budge meant to refer to Rule 23.1, he was not referring to the director demand requirement but only to the requirement of court approval of settlements (SEC Brief, p. 21 n. 11). There is no basis for that distinction: if § 36(b) actions are indeed derivative, all of Rule 23.1 applies. Moreover, it is not true, as the SEC argues, that the director demand requirement does not serve to deter strike suits. In responding to a demand in connection with a frivolous claim, the directors might succeed in convincing the shareholder that his claim is without merit and/or that suit is not in the best interests of the investment company.

6 The Court of Appeals, while adopting Respondent's other arguments, did not pass on the § 16(b) analogy.

Respondent also relies on the fact that although other procedural requirements are mentioned, there appears to be no specific reference in the legislative history of the 1970 amendments to the director demand requirement (Respondent's Brief, pp. 16-19).[7] However, it is not surprising that the director demand requirement was not singled out for discussion. In light of the fact that the predecessor actions were derivative and the fact that Congress evidenced its understanding that a shareholder's action under § 36(b) would be derivative (see Petitioners' Brief, pp. 7-9 and ICI Brief, pp. 19-20 and nn.43 and 44), Congress reasonably assumed that all of the traditional rules pertaining to derivative actions would apply. This understanding is evident from the House bill cited by Respondent (Respondent's Brief, p. 18) which, unlike § 36(b) as passed, required that a plaintiff challenging advisory fees be a "bona fide shareholder." H. 17333, 91st Cong., 2d Sess. (1970). The report accompanying that bill stated that this requirement was not intended as a substantive change. H.Rep.No. 1382, 91st Cong., 2d Sess. at 7 (1970). The reason that no substantive change was intended, and the provision was therefore superfluous, is that the requirement that plaintiff be a bona fide shareholder already applied to all derivative actions. See

7 Although there appears to be no specific mention of the director demand requirement, reference was made to the shareholder demand requirement in the course of testimony on the issue of whether, in addition to shareholders, the SEC should be authorized to sue to recover excessive advisory fees. One of the reasons advanced for allowing such SEC actions was that shareholder suits would be subject to the usual prerequisites applicable to all derivative actions—including the shareholder demand requirement. Hearings on S.34 and S.296 Before the Comm. on Banking and Currency, 91st Cong., 1st Sess. (1969) at 163 (Statement of Ernest L. Folk, III, Professor of Law, University of Virginia).

13 W. Fletcher, Cyclopedia of the Law of Private Corporations § 5972 (rev. perm. ed. 1980).[8]

Finally, Respondent argues that a right of action by an investment company under § 36(b) should not be implied (despite the undisputed evidence of Congress' awareness that derivative actions to recover excessive advisory fees existed at common law and were implied under former § 36 of the ICA, because § 36(b) allegedly created "a totally new cause of action" (Respondent's Brief, p. 20). The error in this argument is that § 36(b) did not create "a totally new cause of action." Rather, § 36(b) represented an effort to cure certain perceived weaknesses in the legal standard ("corporate waste") applicable to common law derivative actions to recover excessive advisory fees. See S.Rep.No. 184, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. and Admn. News 4897, 4901, 4910. Furthermore, Congress was clearly aware that the courts had generally implied a derivative right of action to recover excessive advisory fees under former § 36 of the ICA. See Hearings on S.34 and S.296 Before the Senate Comm. on Banking and Currency, 91st Cong., 1st Sess. at 30 (letter from SEC Commissioner Owens to Senator Sparkman and cases cited in Petitioners' Brief, p. 10). Accordingly, in the absence of any evidence that Congress intended to abolish the pre-existing derivative action (and

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8 Indeed, if, as Respondent argues, a shareholder's action under § 36(b) were not derivative, then it would logically follow that *no* part of Rule 23.1 applies to such an action, including the contemporaneous ownership requirement. Such a result would give license to "strike suits" by permitting persons to purchase shares for the sole purpose of initiating litigation. The two requirements—director demand and contemporaneous ownership—are integral parts of a whole and, therefore, both or neither are applicable.

hence, the right of an investment company to sue its advisor to recover excessive fees), this Court should hold that Congress intended to preserve that remedy as part of § 36(b). *Merill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353 (1982).

Reply to Point II—

The director demand requirement of Rule 23.1 is compatible with § 36(b).

Respondent also argues that the director demand requirement is inconsistent with the operation of § 36(b) and serves no useful purpose. This argument is contrary to the goal of the 1970 amendments to the ICA to strengthen the role of the independent directors and is devoid of merit.

Respondent first claims that § 36(b) preempts all state law remedies for excessive advisory fees (Respondent's Brief, p. 22). Although Respondent purports to rely on *Burks* v. *Lasker*, 441 U.S. 471, 479 n.6 (1979) for this sweeping and novel claim, *Burks* is to the contrary. The existence of additional state law remedies is in no way "inconsistent" with § 36(b), and there is no need for uniformity "as long as private causes of action are available in federal courts for violation of the federal statutes . . . ." *Burks* v. *Lasker*, *supra*, 441 U.S. at 413 and n.6. Respondent fails to cite a single case which holds that § 36(b) has preempted state law remedies. Indeed, even courts which have held that § 36(b) provides the exclusive federal remedy for excessive advisory fees have recognized that state causes of action for breach of fiduciary duty remain as additional remedies. E.g. *Tarlov* v. *Paine*

Webber Cashfund, Inc., 559 F.Supp. 429 (D.Conn. 1983).[9]

Respondent also argues that even if an investment company has a state law remedy for excessive advisory fees, that would not justify a director demand requirement because the legal standard applicable to a common law action for corporate waste is different from that applicable to a § 36(b) action (Respondent's Brief, p. 23). However, even if that were true, the fact remains that the right to recover excessive advisory fees is "a right which may properly be asserted by" an investment company. See Rule 23.1. A shareholder's action to assert that right on behalf of an investment company is therefore derivative and a director demand is required.

Respondent goes on to argue that director demand is useless because the close relationship between the directors of the investment company and the adviser make it unlikely that informal means of redressing excessive fees will be successful (Respondent's Brief, pp. 23-24). This is a cynical view and is inconsistent with the legislative history of § 36(b). If Congress did not feel that the directors were capable of acting with independence, it would not have assigned them the critical role of reviewing advisory fees. See *Burks* v. *Lasker, supra,* 441 U.S. at 485 n.15.[10]

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9 If, as Respondent contends, § 36(b) preempts state law remedies and provides no right of action by an investment company, then the investment company would have *no* judicial remedy to recover excessive advisory fees. That result is hardly consistent with the goal of strengthening the authority of the independent directors.

10 In a slightly different version of the same argument, the SEC contends that director demand would be useless because (1) the independent directors, having already approved the advisory fee

Respondent also contends that the director demand requirement of Rule 23.1 cannot be imposed without converting a procedural rule into a substantive requirement, thereby violating the Enabling Act, 28 U.S.C. § 2972 (Respondent's Brief, p. 25). No cases are cited by Respondent to support this proposition, and *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541, 556 (1949), which the SEC relies on (SEC Brief, p. 8), is inapposite because *Cohen* did not involve the director demand requirement. Moreover, the question as to whether Rule 23(b) had to be amended in light of the *Erie* doctrine was specifically presented to this Court in the Advisory Committee Note of 1946, but this Court did not then amend the Rule and has not done so since because of this consideration. 3B Moore's Federal Practice, *supra*, ¶ 23.1.01. In any event, this issue need not be decided, since this is not a diversity action but rather a suit arising under a federal statute. Accordingly, director demand is properly required by Rule 23.1. See *Levitt* v. *Johnson*, 334 F.2d 815, 819 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965).

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agreement, would not be learning of any new claim; and (2) the bargaining power or the investment company is reduced because it cannot bring a § 36(b) action (SEC Brief, pp. 24-25). These arguments find no support in the legislative history and are also erroneous. Approval of a transaction by the directors does not, by itself, excuse demand before the commencement of a shareholder suit challenging that transaction. See cases cited in Petitioner's Brief, p. 10. Furthermore, although the independent directors are necessarily aware of the fee issue, a demand can serve to focus their attention on some particular question or evidence which was overlooked during their annual review of the advisory contract. And whether or not an investment company can bring a § 36(b) action, it clearly has greater bargaining leverage than an individual shareholder, since it has the power to terminate the contract.

Respondent also claims that director demand serves no purpose because § 36(b)(2) prevents an investment company from terminating a suit (Respondent's Brief, pp. 25-28). That argument is founded on an overly narrow view of the purposes of the director demand requirement and has already been answered (see Petitioners' Brief, pp. 21-24). The only new point raised by Respondent is that in *Lewis* v. *Curtis*, 671 F.2d at 779, 785-86 (3d Cir.), cert. denied, ____ U.S. ____, 103 S.Ct. 176 (1982), the Third Circuit stated "that the same standards which govern the permissibility of directorial termination also dictate the requirement, or lack thereof, of shareholder demand" (Respondent's Brief, p. 27). However, in *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 942, the Third Circuit considered this argument at length and rejected it, holding that:

> ". . . the different purposes served by the business judgment rule and the demand requirement show that the wooden transposition of *Lewis* to this statutory context is inappropriate. *Lewis* was concerned with the futility of demand. It involved an inquiry which is 'intensely factual' and requires particularized pleading by the plaintiff. See *Vernars* v. *Young*, 539 F.2d 966, 968 (3d Cir. 1976). In a conventional shareholder suit, the evaluation of the directors' decision to refuse demand or terminate suit is equally factual, and it makes sense, as we stated in *Lewis*, to employ the same standard of interestedness. However, a statutory presumption of interestedness cannot substitute for the factual inquiry needed to determine whether a demand on directors 'would be likely to prod them to correct a wrong.' *Lewis*, *supra*, 671 F.2d at 785."

We have already dealt with the argument that the director demand requirement is inconsistent with § 36(b)(3), which limits recovery to damages beginning one year before commencement of the action (see Petitioners' Brief, pp. 24-26). Conceding that satisfaction of the director demand requirement will not necessarily reduce the amount of plaintiff's recovery, the SEC objects that the delay caused by the director demand requirement would cause an additional portion of the allegedly excessive fees to pass beyond the reach of the Court (SEC Brief, pp. 25-26). However, the purpose of § 36(b) was not to provide for the recovery of every dollar of excessive advisory fees received by an adviser; the one-year limitation period itself prevents this. Rather, § 36(b) serves to provide an effective equitable remedy against excessive advisory fees which include a monetary award covering the year prior to suit to serve as an incentive. The effectiveness of this remedy is not diminished by requiring director demand which, as the Third Circuit noted, can be "promptly made and expeditiously considered." *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 938.

Conclusion

The judgment of the Court of Appeals should be reversed, and the Complaint should be dismissed.

Respectfully submitted,

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